# MARKET MAKER REPORT ON THE ISSUE OF TAPE RACING

Submitted to the Board of Directors of the

Chicago Board Options Exchange

by

C.B.O.E. MARKET MAKER ASSOCIATION

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The C.B.O.E. Market Maker Association wishes to present its views to the Board of Directors of the Chicago Board Options Exchange on a matter which we feel is vital to the preservation and enhancement of just and equitable principles of trade on our Exchange. We feel this matter, commonly known as the "racing the tape" issue, is a practice that is not in the public interest, or fosters the type of business our Exchange wishes to be associated with now or in the future.

<u>C.B.O.E.</u> <u>History</u> <u>and</u> <u>Structure</u>

The C.B.O.E., since its inception, has given the highest priority to the public needs for a competitive marketplace. We are a membership of open access and have separated all the functions of the traditional "specialist" system in order to assure an environment of fairness to the public order. In separating our functions into three categories: the floor broker, the board broker, and the market maker, we have isolated each member from the alternative sources of income available to the "specialists" on other exchanges. Each function is isolated to prevent conflicts of interest and must perform efficiently in our competitive environment. We do not give priority to "size" in our marketplace. All customer orders compete equally with each other without regard to the size of a customer's financial stature. (Size does not take precedence.) All public orders can take priority over professional traders through the board brokers book. All orders and executions are <u>visable</u> and effected by <u>loud</u> <u>public</u> <u>outcry</u>.

Our members have given the public orders advantages unprecedented in the securities industry, and, unequaled on any securities exchange in the world!

In the past year our members have further enhanced competition by:

1. Cutting floor brokerage commissions to retail member firms.
2. Reducing the minimum differential on options under $3.00* to 1/16th which, through competitive forces, allows opportunity for better net executions of lower priced options.
3. Giving the customer total priority on the book by elimination of the split pricing policy.

Being an Exchange of three years, we have regulated our actions, and continue to do so, ever mindful of the rights as well as obligations of all our members.

We applaud the Exchange for investigating an area of trading which, in our opinion, is not in the public interest, and which we believe is in violation of the spirit of Rule 10b-5.

The members of the C.B.O.E. Market Maker Association have formulated answers to some questions that we deem relevant to rule and policy formation in this area. The questions we have attempted to answer are:

1. Is there a problem?
2. Will the high speed ticker alleviate the problem without further regulation?
3. What is the role of our marketplace and its participants?
4. If everyone has the right to do this type of business, why should it be regulated?

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* previously $2.00

Is There a Problem?

There have been numerous complaints filed with the Trading Procedure Department. The problem was accentuated by a few firms who consistently took advantage of time disparities between the actual trades effected on the New York Stock Exchange and the transaction being disseminated via the price reporting system. This caused complaints from floor brokers whose orders were tied to the price of the underlying stock, and market makers who were trying to fill public orders and were concerned about constant "picking off" done by these traders. This resulted in smaller, less liquid markets for the public.

It was these two complaints that started our investigation of whether this practice was consistent with just and equitable principles of trade in a derivative market such as options, which by their nature are subordinate to the actions and value of the underlying stock.

After some investigation, it became apparent that not only was it improper now, but in the future with the abolition of Rule 394, which will cause markets to drift away from the current primary marketplace through competitive pressures and the composite tape, the chances for this type of trading increase 100-fold. The firm trader who wishes to take stock will have the same rights to do so, but will then have the opportunity to trade options ahead of the composite tape. Our markets in options are subordinate to, and based on, the market value of the underlying security. If this type of action were to happen in active markets, the willingness and ability of a market maker would be subject to the firm trader's advance knowledge of non-disseminated information. This lessening of willingness and ability to make markets would severely lessen liquidity at a time when the public needs it most.

## Will the High Speed Ticker Alleviate the Problem?

While the high speed ticker has certainly helped a great deal, the input to the terminal is still done by someone this Exchange has no control over, and someone who has no incentive to rush his input into a terminal. In the coming security markets the input will be done by more than one person from an increased number of input stations. The possible abuses of this trade information could present itself on our Exchange and have a direct effect on our performance as a marketplace. With a rule abolishing the tape racing practice there would be no economic incentive to "error" or delay price reporting; rather there would be just the opposite effect. The incentive would be to report trades fast so that hedging actions or arbitrage could be effected as soon as possible.

Even assuming that all input was up to date, we are still relying on a machine to eliminate an undesirable trading practice rather than our own sense of trading ethics.

A rule prohibiting the racing-the-tape would emphatically circumvent failings of a computer system and human delays of input.

## What is the Role of the Marketplace and its Participants?

When we speak of market makers in the marketplace we must keep in mind that market makers are not by any means collective in their competition. There are 13.2 (average) market makers in each crowd. In a three stock group, such as KG-WY-MOB, there are 28 separate series they must represent. Many, if not most market makers, function in the area of arbitrage. As a matter of fact, the arbitrage function has been so effective through the expertise of our floor members in spreading techniques and stock-option strategies, that we believe that part of the problem of tape racing may stem from the inability of some off-floor traders to compete in a competitive environment such as ours. The market-making system also brings up the question of the relative worth of off-floor arbitrage activities which may be important to the one-man "specialist" system but of less importance to a system which includes arbitrageurs efficiency in its floor function.

The role of our marketplace is derivative in its nature. The value of our options are based on a variety of factors, the most important of which is the price of the underlying stock. To reflect a true market in options, or for the public to put a value on an option, a visable and accurate value must be accorded to the underlying security. For example:

Customer "A" places an order to sell IBM April 220's at 2 points above parity (stock at 260).

Customer "B" places an order to sell IBM April 220's @ 42 and puts it on the book.

The tape is late and both the floor broker and the board broker think the stock is at 260. The off-floor trader knows the stock is at 263½ and comes in to the market and buys these options at 42½? IS THIS THE PROPER FUNCTION OF ARBITRAGE?

If the floor broker was aware of the price of the underlying stock his customer, Customer "A", would <u>not</u> have been executed and the interest of the customer would have been served. If the price had been visable, the competition would have assured Customer "B" a fair price. It is our opinion the price, as in this example, would have been at a higher level than 42½ for several reasons.

1. The cost of doing arbitrage or hedging transactions is lower for the floor trader, and this passes the savings on to the customer.

2. Competition forces a market maker (or anyone else) to pay true value or the trader competing with him may get the trade. If I say "42½ bid" to try and do the arbitrage for 1 point the man next to me may say "43 bid" and accomplish the arbitrage for less.

3. Alternative spread advantages present themselves that would not be available on an ordinary basis. For example, if the trader has established the relationship between the April 220's and the July 220's should be a 5 point differential and at this time the trade up to 263½ was <u>visable</u>, the trader could buy the April 220's at 43. This would allow him the alternative of arbitrage or selling the July 220's at 48½. His alternatives both center around a 3/8th potential profit, and allow liquidity and execution performance at a higher level than the tape racer would allow. If at the time of <u>visable</u> print the market maker did not respond, or the firm trader made the <u>best</u> <u>bid</u> <u>first</u>, or bid a greater amount than the market makers or the public, then the system has worked as we feel it should. The firm trader would have used his capital and expertise to fill the customer order at the best possible price, and <u>Customer "A" has not been usurped by a system which shields the customer from true value and price. Customer "B" has received the competition for his order that we consistently assure him exists!</u>

4. The lack of true competition for the customer order renders academic who can give the best execution, since one member is using information that has not been publicly disseminated in order to circumvent competition. The arbitrage activities and function in the marketplace is intended for true disparities in price not for disparities caused by a lack of visibility of the actual market.

5. The market makers deal on independent profit requirements, and when doing arbitrage still have to worry about other market makers and firm traders engaging in the same

activity. They are interested in the specific return that they initiated the transaction for. Even dealing in the underlying stock they must worry about other market makers and firm traders engaging in the same activity. In essence, when the differential between the option and the stock is out of line the market maker competition assures a minimal differential. But, the differential is <u>only</u> minimal when everyone competes with equal knowledge.

The one thing the market makers have never been concerned about is competition from genuine arbitrage firms. Arbitrage is a valued asset to liquidity on our floor. There are many large arbitrage firms that compete with floor operations effectively and vigorously. We welcome their competition.

However, it should be pointed out that market makers are required to contribute liquidity <u>at all times</u> and <u>in all options</u>. We are not afforded the opportunity of sitting out tough trading markets. We accept this responsibility and constant scrutiny as part of the price of our franchise. We will not, however, give up our rights to those who accept no direct responsibility for making markets to option investors and wish to circumvent direct and open competition by use of advance information to the detriment of our market making system and our option investors.

<u>If Everyone has the Right to do This Type of Business, Should it be Regulated by the Exchange</u>?

We realize that highly capitalized firms, and market makers, have the opportunity to set up an operation such as those that race-the-tape now. However, by accepting the above premise, we are eliminating the lesser capitalized, yet competitively effective, market makers from competing on an equal basis with the larger firms. This would be contradictory to the system we have established. The intimidation caused by the smaller traders' wariness of his secondary position can only mean increased cost to the public customer by the fact that less people will be competing for his order. We will be putting the market in options back into a system of "might makes right" rather than the current system of equal competition for all orders on an equal basis. If tape racing were allowed, market makers who had the financial capability would set up a communication system thereby making the market makers without this capability less competitive. Then again, if a great number of market makers have the ability to create their own communication system how, since the logistics of booth space both on the C.B.O.E. and the N.Y.S.E. would be a critical determinant as to the effectiveness of such a communication system, would the Exchange handle the allocation of booth space?

<u>Summary</u> <u>and</u> <u>Conclusion</u>

We do not believe that a self-policing organization, such as ours, should wait for federal dictate before eliminating an undesirable trading practice.

We believe the decision of the Board should be clear, decisive, and immediate.

When we strip ourselves of semantics, the question we must ask ourselves is:

> <u>Should one member, with prior knowledge of non-disseminated news be allowed to screen his actions under the defense of "bona fide arbitrage" in order to circumvent open, visable, and direct competition for the customer order?</u>

We strongly believe that this practice is detrimental to our Exchange and the public, and we trust you will show, as you have in the past, a total concern for open competition and a visible marketplace.